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Post-Crisis Recovery in Asia

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Background

The “Asian crisis” was a major setback to the region. The countries most affected—Thailand, Indonesia, Malaysia, Philippines and Republic of Korea—suffered a massive outflow of capital which has not yet fully reversed, and an unprecedented sharp decline in real GDP. Hong Kong, China, and Singapore, which had stronger fundamentals, were also affected, while the People’s Republic of China (PRC); Taipei, China; and India held up relatively well and had a stabilizing influence on the region. By mid-1998, the crisis countries started a recovery which continued despite the global slowdown last year and is likely to gain momentum this year and next.

In looking at the region as a whole, the two large countries, the PRC and India, should be viewed separately. For the rest of Asia, we can distinguish 3 phases of the recovery (Chart 1):

- The initial “V-shaped” phase, which started around mid-1998, came earlier and was more vigorous than everybody expected.
- The externally induced slowdown, starting in the later part of 2000, lasted through 2001.
- The acceleration of growth, starting in the early part of this year, is likely to continue into next year and bring growth close to its potential.

There have been 3 driving forces behind the recovery:

- Domestic macropolicies which stimulated domestic demand
- Expansion of global demand which supported export growth
- Structural policies which strengthened the economy’s fundamentals and contributed to restoring confidence.

A potential fourth driving force, a major reflow of capital, has been absent, so far, except in the Republic of Korea. Several obstacles seem to be responsible for this:

- domestic political uncertainties;
- doubts about the consistency of the government’s reform course;
- lack of internal security;
- defects in the legal system;
- lingering governance and corruption problems

To the extent that the recovery differed between individual countries, it reflected the differing strength of the driving forces as well as of the obstacles (Chart 2).

Phases of the Recovery

The Initial Phase. The recovery was preceded by stabilization of the banking system and of the foreign exchange market. This allowed a gradual reduction in interest rates to below pre-crisis levels (Chart 3). Lower interest rates, together with a belated shift in fiscal policy from a

restrictive to an expansionary course, arrested the fall in domestic demand and led to a turnaround in GDP growth. Subsequently, exports played a crucial role in sustaining a brisk recovery (Chart 4). The pickup in exports was due to buoyant world demand, thanks to the strong expansion of the US economy, and to the effect of the large exchange rate depreciations – on average about 30% in real terms (Chart 5).

The Slowdown. Unlike the 1997 crisis, which was largely homemade, the 2001 slowdown was externally induced. Falling global demand was transmitted to Asia via a fall in exports (Chart 6). The fall in global demand hit those economies hardest that were the most open and were also heavy exporters of IT products. This changed the relative fortunes of the countries. Most vulnerable were Singapore; Malaysia; Taipei,China; Hong Kong, China; and Philippines; while India, Indonesia, and the PRC were relatively little affected (Chart 7). The former crisis countries withstood the external shock better than some observers had feared. Their average growth fell to about 1%, while growth was close to zero in Hong Kong, China, and negative in Singapore and Taipei,China.

Three elements were crucial in mitigating the impact of falling exports of all Asian countries on their GDP:

- First, expansionary monetary and fiscal policies supported domestic demand. Interest rates came down further, except in Indonesia, (Chart 3) and budget deficits rose significantly in most countries; only the Republic of Korea and Singapore had a modest surplus (Chart 8).
- Second, structural reforms have made the financial and corporate sectors more resilient.
- Third, flexible exchange rate policies in most countries allowed rates to moderately weaken (Chart 5). Together with a reconstitution of foreign exchange reserves to high levels, and a reduction of short-term external debt, this provided a cushion against the adverse external shock.

As the crisis countries proved to be more resilient than in 1997, investor confidence held up despite the slowdown. There were no market panics, and there were no major rating downgrades. While 2001 was certainly a difficult year, the situation was far from being a “second Asian crisis”.

The Acceleration. With the start of the US recovery late last year, Asian exports have turned around, (Chart 4) and this is being reflected in higher growth in the region. For this year, growth in India and the PRC is expected to accelerate to 6 and 7%, and average GDP growth in the other countries is forecast to rise to some 4%. If nothing goes wrong in the global economy—and here the major risks are political and, therefore unpredictable—growth is projected to rise further to 5-6% next year. This is probably close to the potential medium term growth (Chart 9).

Policies to Sustain the Recovery

In addition to continued expansion of foreign demand, a sustained Asian recovery, this year and beyond, is contingent on sound economic policies at home. Markets will closely watch governments’ actions, and their judgement will influence confidence and investor interest in individual countries. To sustain the pace of recovery, I would emphasize a number of challenges in the macroeconomic as well as in the structural areas:

Macroeconomic Policies. Since in most countries, domestic demand growth is not yet sufficiently robust, supportive macroeconomic policies continue to be needed:

- Monetary policy should remain accommodating or neutral, as long as there are no signs of renewed inflationary pressure. In most countries, the expected rise in interest rates in the US and in Europe need not be fully matched. The scope for maneuver will, of course, have to be decided in the light of the differing circumstances in individual countries. There is probably less scope in the Republic of Korea, and little in Hong Kong, China.
- Fiscal policy should stay mildly expansionary in the short run—and this has indeed been planned in most countries. Over the medium-term, however, fiscal policy must be re-oriented towards consolidation. This is particularly important in Indonesia, the Philippines and Thailand, where public debt is already high. It is also crucial in India where current deficits are not sustainable, and eventually it will also become necessary in the PRC. Restoring a sound fiscal position in all countries is essential to keep public debt within tolerable limits, to maintain confidence in financial stability, and to prevent upward pressure on long-term interest rates, which would dampen growth.
- Exchange rate policy should remain flexible to cushion external shocks to the economy. Market tendencies to weaken or strengthen the currency should, therefore, be allowed to exert themselves.

Structural Policies. While considerable progress has been made—and this is often overlooked, there is still a large unfinished agenda of further reform and restructuring in order to establish a sound base for longer-term growth:

- The completion of banking sector reform and corporate restructuring should be on top of the list. A lot has still to be done, in particular in Indonesia and Thailand.
- To foster competition and productivity, as well as to attract needed foreign capital, deregulation, market opening and privatization should continue.
- Finally, to create an environment conducive for business investment, the efforts that were started during the crisis to improve transparency, governance, and the legal system should be intensified.

Asia has a considerable growth potential, bolstered not only by high savings and a growing labor force, but also by an entrepreneurial tradition, an increasingly well-educated population, and increasing integration with the global economy. If the global economy is not derailed by political events and Asian governments pursue the right policies, Asia will remain the fastest growing region of the world.